United States Court of Appeals

for the Second Circuit

PETITIONER'S REPLY BRIEF

Affidavit

76-6040

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket No. 76-6040

UNITED STATES OF AMERICA and WALTER ROSS,
Revenue Agent, Internal Revenue Service,

Petitioners-Appellants,
Cross-Appellees,

—v.—

GEOFFREY DAVEY, As Secretary of THE CONTINENTAL CORPORATION,

Respondent-Appellee,
Cross-Appellant.

B p/s

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

REPLY BRIEF OF PETITIONERS-APPELLANTS-CROSS-APPELLEES

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REPLY BRIEF OF PETITIONERS-APPELLANTS-CROSS-APPELLEES

Preliminary Statement

This brief contains the position of the United States of America and Revenue Agent Walter Ross, petitioners below, in reply to the appellee-cross-appellant brief of respondent, Geoffrey Davey, Secretary of the Continental Corporation. The issues raised by respondent's cross-appeal are: whether the District Court erred in finding that the summoned computer tape was data that could be summoned pursuant to 26 U.S.C. § 7602; whether the summoned data was material and relevant; and whether taxpayer failed to sustain its burden to deny enforcement

of the proper summons. In addition to its position with regard to these issues raised by cross-appellant, the United States herein replies to basic misconceptions espoused in the appellee's brief and takes issue with appellee's reliance on facts not in evidence.

ARGUMENT I

THE DISTRICT COURT ORDER SHOULD BE AFFIRMED INSOFAR AS IT ENFORCED COMPLIANCE WITH THE INTERNAL REVENUE SERVICE SUMMONS.

POINT I

The IRS Summons Seeks Data Which May Be Relevant To The Audit.

The Internal Revenue Service summons was issued pursuant to the authority contained in Section 7602.* By Section 7602 Congress specifically authorized the Internal Revenue Service to summon "any books, papers, records or other data which may be relevant or material" to the determination of a taxpayer's tax liability. The authority under this Section is broad and should be liberally construed. *de Masters* v. *Arend*, 313 F.2d 79, 87 (9th Cir. 1963); *Falsone* v. *United States*, 205 F.2d 734, 742 (5th Cir.), *cert. denied*, 346 U.S. 864 (1953); *In re International Corp.*, 5 F. Supp. 608 (S.D.N.Y. 1934). *Cf. United States* v. *Bisceglia*, 420 U.S. 141, 145-46 (1975). The Court of Appeals for the Second Circuit has held that the judicial test is not whether the records sought will or will not contradict the taxpayer's tax

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* Section references are to the Internal Revenue Code of 1954, as amended (26 U.S.C.), unless otherwise specified.

returns but is "whether the inspection sought 'might have thrown light upon' the correctness of the taxpayer's returns." *Foster* v. *United States*, 265 F.2d 183, 186-87 (2d Cir.), *cert. denied*, 360 U.S. 912 (1959). *United States* v. *Shlom*, 420 F.2d 263, 265 (2d Cir.), *cert. denied*, 397 U.S. 1074 (1969); *see United States* v. *Acker*, 325 F. Supp. 857, 862 (S.D.N.Y. 1971) (Court enforced I.R.S. summons to produce Board of Directors minutes of Standard Oil Co. because they may be relevant to the audit).

In the present proceeding, the summons allows the IRS to examine the financial data of the taxpayer in the very media which the taxpayer has voluntarily selected to embody its financial accounts and records. Unlike what cross-appellant has stated, the summons does not seek to have taxpayer "prepare," "create," "re-arrange" anything (Geoffrey Davey Brief ["Davey Br."] 9). It merely requires the taxpayer to free for audit purposes 37 reels of computer tape which the taxpayer has maintained solely for purposes of compliance with Rev. Rul. 71-20, Section 6001 and Treas. Reg. § 1.6001-1.*

The testimony at the hearing developed that the summoned tape reels constitute original books of entry and thus are an integral part of the audit verification process (A-130, 132-36, 138-39).** An IRS Agent testified that use of the tape reels provided the means by which

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* Section 6001, Treas. Reg. § 1.6001-1 and Rev. Rul. 71-20 are set out in Appellant's Brief, pp. iv-v.

** Cross-appellant, in its brief, states that it does not have a computerized accounting system (Davey Br. 4). Cross-appellant then fills a full page explaining that it uses computers with respect to expense and loss information pertaining to twelve of its subsidiary insurance companies, that one of its subsidiaries is

[Footnote continued on following page]

the IRS could determine whether the auditor had available all the financial data of the taxpayer. (A-123.) The taxpayer's own counsel conceded to much the same effect:

> Mr. Rockler: . . . The tape would be useful to establish that it was a proper printout of the tape.
>
> The Court: How did they establish it if they don't have the tape?
>
> Mr. Rockler: They can't establish that. If that were the purpose of the Government requesting the tapes we would be glad to make them available and they could check in the printout. We would be glad to make that available to them.

(A-62.) The hearing also made clear that, especially in light of the mammoth size and complexity of Continental Corp., use of the tape would greatly reduce time expended on the audit and greatly enhance its efficiency. (A-118, 121-122)*

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a computer facility which services the other subsidiaries and that its income reported as taxable on the tax return under audit is derived with the assistance of computers and the very computer tape which the IRS now has summoned for its audit (Davey Br. 4, 5).

* To highlight the need for the tapes, the Court need only rely on the cross-appellant's assertion that for *each* auditing decision to be examined, without considering audit accuracy, would amount to approximately 10 hours (Davey Br. 6, n.3). Multiply the 10-hour figure, suggested by cross-appellant, by the large number of audit decisions. Compare this tremendous figure with the brief period of time needed to run a computer-assisted audit. Thus, the cross-appellant analogy of producing the tape as the same as supplying "scratch paper" or "dining facilities," demonstrates a grotesque misconception of the function of the computer in the taxpayer's own financial accounting system and the purpose, manner and method in which routine IRS audit examinations are conducted.

In weighing the evidence presented at the hearing, the District Court appropriately observed that:

> [a]n audit in order to be effective must be independent. The taxpayer cannot dictate what information is to be examined for mistake or evasion. [citation omitted]

United States v. *Davey*, 404 F. Supp. 1283, 1284 (S.D. N.Y. 1975). With this in mind, the District Court quite properly concluded that the summoned computer tape will enable the IRS "to produce the audit trail necessarily required by it to complete its audit of Continental Corporation's tax returns." *United States* v. *Davey*, *supra*, at 1284-85. In so finding the Court aptly noted that:

> The fact that respondent's employer may have complied with section 832 of Title 26 and the statement of expenses as approved by the National Convention of Insurance Commissioners (*See* Title 26, United States Code, Section 832(b)(6)) does not for purposes of audit determine what records may be required to be produced.

United States v. *Davey*, *supra*, at 1284.

POINT II

The Computer Tape Is "Data" That Can Be Summoned Pursuant To Section 7602.

Section 7602 broadly provides that during an audit the IRS may summons a person to produce "books, papers, records, or other data." *Id.*. Cross-appellant argues that this means less than what it says: that this phrase refers exclusively "to visible and legible books and records—not to intermediate processing tools such as computer tapes."

(Davey Br. 11).* Significantly, nothing is cited for this crucial proposition. In fact, cross-appellant's argument is at odds with the broad definition which courts give to the phrase "other data." In a recent decision, the Eighth Circuit has emphasized the broad approach that should be taken in interpreting "other data". *United States* v. *Campbell*, 75-2 USTC ¶ 9760 (8th Cir. 1975).

Lacking case law to support its position, cross-appellant suggests what might loosely be termed a negative pregnant: It points to the fact that in one case the IRS sought "print-outs" from a third party credit reporting agency, that in federal civil and criminal cases "print-outs" have been admitted as evidence under the business record rule,** and that Rev. Proc. 64-12, issued prior to Rev. Rul. 71-20,*** requires taxpayer to maintain his records in a visible and legible manner. Apparently, cross-appellant asks the Court to conclude from these facts that Section 7602 may go so far as to require production of print-

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* The only qualified expert at the hearing established that the computer tape is a product itself and not an intermediate processing tool. (A-142.)

** Cross-appellant's further statement that Fed. R. Civ. P. 34 is broader in scope than Section 7602 is in error. Case law does not support this statement. *See, Falsone* v. *United States, supra,* 205 F.2d at 742. *Cf. United States* v. *Ponder,* 475 F.2d 37, 39 (5th Cir. 1973).

*** The opinion below discusses both Revenue guidelines:

> The Internal Revenue Service in issuing Revenue Procedure 64-12 with respect to "Guidelines for record requirements to be followed in cases where part or all of the accounting systems are maintained within automatic data processing systems" indicated in Sec. 4 ADP Guidelines what would be required. In Rev. Ruling 71-20 it required that in effect the tapes were to be retained like any otehr books or records "so long as the contents may become material in the administration of any Internal Revenue Law."

United States v. *Davey, supra,* 404 F. Supp. at 1284.

outs, but not computer tapes. As indicated by the decision of the Court below, this reasoning is plainly without substance. See, *United States* v. *Davey*, 404 F. Supp. at 1284.

The standard for appellate review of the District Court's findings of fact is that the findings must be affirmed "unless clearly erroneous". Fed. R. Civ. P. 52(a); *Carrion* v. *Yeshiva University*, Doc. No. 75-748 (2d Cir. May 7, 1976), slip op. at 3620; *United States* v. *Zack*, 521 F.2d 1366, 1368 (9th Cir. 1975); *see, United States* v. *McCarthy*, 514 F.2d 368, 372 (3d Cir. 1975). The taxpayer has simply failed to meet its burden in this appeal.

Given the evidence adduced below and the District Court's findings, there is no weight to cross-appellant's argument that production of the tape is for the "convenience of the agents" and thus not properly the object of an IRS summons. (Davey Br. 8-10). Cross-appellant's argument is founded upon the assumption that the taxpayer alone, not the IRS, may determine what books and records are necessary and appropriate to verify the taxpayer's own tax liability. Such an assumption plainly defeats the very purpose of an audit. *In re International Corp., supra*, 5 F. Supp. at 611. *See United States* v. *Acker, supra*, 325 F. Supp. at 861-62.

POINT III

The Summons Seeks A First Inspection Of Non-Redundant Material.

Cross-appellant tries to cast the summons in terms of a second inspection of documents or an inspection of data already available. (Davey Br. 12-13). However, in the instant matter the Revenue Agent has not closed the audit on the involved tax years and has *never* seen the requested

data, the computer tape, although he has made numerous requests beginning at the very initiation of the involved audit. *See, United States* v. *Schwartz*, 469 F.2d 977, 983-85 (5th Cir. 1972) (distinguishes "first" and "second" inspection); *cf. Norda Essential Oil & Chemical Co.* v. *United States*, 253 F.2d 700 (2d Cir. 1958); *National Plate & Window Glass Co.* v. *United States*, 254 F.2d 92 (2d Cir. 1958).

In each of the cases cited by Cross-Appellant, but unlike the instant case, the very material summoned by the agent had already been physically viewed and reviewed by the petitioning Revenue Agent. In addition, none of the cases cited by the cross-appellant for its position, unlike the instant case, relate to a taxpayer under continuous review due to its size or complexity.*

The essense of cross-appellant's argument is that "all the information that could be found on the tapes has already been made available . . ." (Davey Br. 13). It was of critical importance to taxpayer's position to somehow establish that the voluminous pre-set print-out pages heretofore produced from the summoned tape reels by taxpayer, for their own various fiscal purposes, and now offered for IRS examination, make the summoned tape reels, themselves, redundant. The taxpayer failed to establish this position because the pre-set print-out sheets are not merely a visual counterpart of a machine record but rather are a compilation of scattered information at a particular point in time.

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* Notwithstanding the above, in one case cited by the cross-appellant, the Court found that "The burden of showing an abuse of the Court's process is on the taxpayer, and it is not met by a mere showing . . . that the records in question have already been once examined." *Untied States* v. *Powell*, 379 U.S. 48, 58 (1964).

The only witness qualified as a computer expert at the hearing was asked whether the print-out information was equivalent to the computer-tape information. The expert found it not to be usefully equivalent. (A-142-44). According to the expert:

> . . . there is this dimension of form. It is really extremely important. Talking about equivalent information sources, in these days of massive masses of data, it is no longer limited to content only. It has to be the form in which it exists.

(A-143).

After taking testimony on the need for the tape in the face of the proferred print-outs, the Court found the print-out sheets to be inadequate for IRS audit purposes. *United States* v. *Davey*, *supra*, at 1284-85. We submit this finding is amply supported by the evidence adduced below. (See, *e.g.* A-118, 121-22, 132-36, 142-43).

POINT IV

The Burden Of Proof In A Summons Enforcement Proceeding.

Once the Government demonstrates that there is a legitimate purpose, that the inquiry is relevant to that purpose, that the information sought is not already within the possession of the IRS, and that the proper administrative steps were followed in issuing the summons, it is well established that at a summons enforcement hearing the taxpayer has the strict burden of showing abuse of the court's process. *United States* v. *Donaldson*, 400 U.S. 517, 526-27 (1971); *United States* v. *Powell*, 379 U.S. 48, 58 (1964). In *In re Magnus*, 196 F. Supp. 127, 128 (S.D.N.Y.), *aff'd.*, 299 F.2d 335 (2d Cir. 1961), *cert. denied*, 370 U.S. 918 (1962) the District Court observed:

> It would be intolerable if, by the mere filing of a motion to quash, the taxpayer could hold up every examination or investigation until the Government proved the negative that it was not so violative. *In re Magnus*, *supra*, 196 F. Supp. 127, 128 (S.D.N.Y. 1961).

On appeal, this Court added:

> . . . [W]ere the government forced to establish the necessity for every phase of its investigations into taxpayers' financial affairs before proceeding, "it is impossible to see how the statutes can be enforced at all . . ." *In re Magnus*, 299 F.2d 335, 337 (2d Cir. 1962).

Thus, cross-appellant's brief on this appeal is in error insofar as it suggests that the IRS must establish the necessity of every phase of its audit and bears the burden of proof with respect to every possible argument thrown up by the taxpayer. The instant summons was enforced because the Court was satisfied that the Government had made the limited showing required by *Powell*, thus shoulrering taxpayer with the burden of proving that such enforcement would constitute an abuse of the Court's process. *United States* v. *Powell*, *supra*, at 57-58. Stated simply, taxpayer utterly failed to sustain its burden.

ARGUMENT II

THE DISTRICT COURT ERRED IN REQUIRING THE I.R.S. TO PAY FOR AND TO WORK WITH DUPLICATES OF THE SUMMONED RECORDS.

POINT I

Cross-Appellant Has Failed To Justify The District Court Decision To Restrict The IRS To Duplicates.

Contrary to the assertions in the cross-appellant brief, the IRS has a consistent policy of seeking to safeguard taxpayers' computer tapes. The relevant IRS guidelines state when computer tapes must be taken off of taxpayer's premises, safeguard for the physical care of the tapes and the disclosure provisions of the Internal Revenue Code will be taken: there is no reference to duplication. CCH Internal Revenue Manual ¶ 42(13)1.7(3).

The Courts have not previously restricted the IRS to an examination of duplicates of original summoned data. The cases cited by cross-appellant on this issue relate only to considerations of the inspection location and the sheer volume of the data. (Davey Br. 15). One of the cited cases holds that the fact a government agency had access to other records "does not destroy the Government's right to inspect the original and primary records of the Corporation". *United States* v. *Luther*, 481 F.2d 429, 432 (9th Cir. 1973). And within another cited case the Court stated: "In our opinion, it was not unreasonable to compel production of records which the law required to be kept and from which the reports filed with the Secretary were made." *Goldberg* v. *Truck Drivers Local*, 293 F.2d 807, 814 (6th Cir. 1961).

The taxpayer has yet to direct the Court to a case where the IRS sought original records during an audit but was restricted to duplicates. The Government's position that the District Court was without authority to impose the "duplicate" restriction is thus unfettered by cross-appellant's discussion of a District Court's ability to alter the inspection location or modify the breadth of a summons to only foreseeable relevant data. *In re Magnus*, 311 F.2d 12 (2d Cir. 1962), *cert. denied*, 373 U.S. 902 (1963); *United States* v. *United Distillers Products Corp.*, 64 F. Supp. 978 (D. Conn.) *aff'd.*, 156 F.2d 872 (2d Cir. 1946). The Government's position that it is entitled to the originals is particularly compelling here, where the tapes have been retained by the taxpayer specifically because of Rev. Rul. 71-20, directing retention of such tape as part of the taxpayer's books and records.

Cross-appellant is operating under the misguided theory that it is the Government that must come forward to establish in each summons enforcement proceeding that it will conduct the examinations in a regular manner which will safeguard taxpayers records. Cross-appellant is in error. Rather, it is the taxpayer that must demonstrate some irregularity in the manner in which the IRS is going to conduct its inspection. In a case, cited by cross-appellant, the Court stated:

> In the absence of proof to the contrary, there is a presumption of regularity in the proceedings of a public officer. The burden is upon the party complaining to show otherwise. [Citations omitted.]

Goldberg v. *Truck Drivers Local*, 293 F.2d 807, 812 (6th Cir. 1961).

Throughout these proceedings, cross-appellant has couched its argument in terms of an accident which *may*

happen if the IRS examines the tapes. (Davey Br. 16-18). There was no evidence as to how respondent will actually suffer assuming *arguendo* that the tapes will be harmed. Thus, it was the mere "possibility" of an unspecified harm, no more, which the District Court relied upon in directing production of duplicate tape. Reliance upon possible, undefined harm, however, simply cannot suffice as a basis for restricting the enforcement of a summons as issued. Moreover, even had taxpayer demonstrated more than the mere "possibility" of harm, there was absolutely no evidence presented by taxpayer to demonstrate why, once the tape is duplicated, the Government should not be entitled to examine the original record rather than a duplicate.*

POINT II

The Taxpayer Should Properly Bear The Cost Of Making Duplicate Records For Itself.

The IRS is summoning specific computer tapes that the taxpayer has maintained for the IRS. Compliance with the present summons could have amounted to no cost at all to the taxpayer who merely had to produce this tape for IRS audit inspection. But, instead, the taxpayer raised the spectre that during IRS examination some accident might occur which would somehow injure the tapes, thus "necessitating" duplication of tapes at a cost which has been established to be in total amount approximately $1,300. A cost of $1,300 to indemnify itself against damaged records cannot be seriously thought of

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* The cross-appellant referral to IRM ¶ 42 (13) 1.6(8)(b) in respect of the IRS routinely sending tape through regular mail is an erroneous reference. That paragraph refers only to procedures adopted for generalized audit systems tapes used as a teaching device and does not refer to tapes containing taxpayer records.

as anything but a reasonable cost of doing business to a billion dollar multi-company casualty insurance corporation. *See, United States* v. *Friedman*, 76-1 USTC ¶ 9328 (3d Cir. 1976); *see also, California Bankers Assn.* v. *Shultz*, 416 U.S. 21 (1974). The Government's position in this regard is strengthened, not weakened, by cross-appellant's statement that for the past 10 years taxpayer has annually incurred substantial expenses in respect of IRS audits without having sought reimbursement from the Government. (Davey Br. 19, 20).*

Finally, cross-appellant implies that the District Court opinon articulates a reason for requiring the IRS to pay the duplication costs. (Davey Br. 23). In fact, there is absolutely no reason discussed by the District Court in its opinion. Cross-appellant's reasoning as to why the IRS should pay to examine this taxpayer's records is premised on the erroneous assumption that the summoned records are redundant and serve as no more than a convenience to the IRS. As the Court below found, and as the record amply demonstrates, the IRS is entitled to the summoned records, to which the IRS has never had access, in order to effectively and efficiently conduct the audit examination.

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* Cross-appellant suggests that the IRS's own administrative practice, *in every instance*, is to reimburse taxpayers for *any* duplication costs in making copies of materials available for the IRS. (Davey Br. 20.) A reading of the Internal Revenue Manual ¶ 403(21), quoted in Davey Br. 2a, demonstrates how grossly cross-appellant overstates the IRS practice. The Manual states that if an examining officer needs copies of "only a few documents", it is "generally" preferable to pay taxpayer for such copies. *Id.*

POINT III

The Court On Appeal Should Disregard Facts Contained As Statements In The Brief Of Cross-Appellant But Not Admitted In Evidence By The Trial Court.

An IRS summons enforcement proceeding is bound by the Federal Rules of Civil Procedure unless the District Court specifically limits there Rules. *United States* v. *McCarthy*, 514 F.2d 368, 372 (3d Cir. 1975). On review, the Court of Appeals is limited to a review of the facts appearing before the trial court as evidence. *See, Panaview Door & Window Co.* v. *Reynolds Metals Co.*, 255 F.2d 920, 922, 926 (9th Cir. 1958).

In its cross-appeal brief respondent has relied upon affidavits in presenting a statement of facts which is contested by the petitioner. (Davey Br. 3-7). These affidavits were only part of the respondent's answer to the petition and order to show cause which brought on the enforcement hearing. At the hearing itself the same individuals who had signed respondent's affidavits testified under eath. Yet, respondent's counsel did not even seek to introduce the affidavits into evidence.

In fact, when the trial court specifically inquired of counsel for respondent as to whether these affidavits which had been identified were to be offered into evidence, counsel for respondent said, "No, Your Honor" (A-75). But, now, on appeal, respondent refers to these same affidavits as if they were placed in evidence. Certainly, where an affiant is called to testify by respondent, his prior affidavit, which was not even offered into evidence before the lower court, cannot be considered on appeal. *See, Siano* v. *Helvering*, 79 F.2d 444, 446 (3d Cir. 1935).

Furthermore, this appellate court must not consider extra-record evidence merely referred to in the brief of cross-appellant. *United States ex rel Collins* v. *Ashe*, 176 F.2d 606 (3rd Cir. 1949). Cross-appellant chose in its brief to cite to numerous statements from a Journal of Accountancy article to establish certain factual matters. At the hearing respondent failed to read any of the now cited statements into the record. *See*, Federal Rules of Evidence, Rule 803(18). (Davey Br. 18; A-106-07). These statements, in the brief of cross-appellant cannot cure omissions in the record. *United States* v. *Van Dusen*, 78 F.2d 121, 122 (8th Cir. 1935).

It is apparent that cross-appellant is arguing its case to this Court as if it were a re-trial. It is not. A further misuse of this appeal is the citation to a second Journal of Accountancy article claimed to be by one who is an IRS consultant on the computer audit program. (Davey Br. 14). This article is presented as if it were testimonial evidence of the policy position of the IRS. *Id.* Respondent chose not to call the writer to testify at the hearing on this matter. The Government has not conceded the qualification of this writer or the authenticity, competence or relevance of the article. This Journal article is absolutely not in the record, and the use of this article is a clear abuse of this Court. It has long been held that statements of counsel cannot bring into the record facts not disclosed by it. *United States* v. *Addonizio*, 449 F.2d 100, 103 (3rd Cir. 1971). *Leonard* v. *Field*, 71 F.2d 483, 487 (9th Cir. 1934).

Therefore, this Court should disregard statements in the cross-appellant brief which are supported by matter not in evidence.

CONCLUSION

For the foregoing reasons, the involved IRS summons should be ordered enforced as issued, and the judgment of the District Court should be reversed only insofar as it contains a protective order requiring the Internal Revenue Service to examine duplicates of the summoned records and to reimburse the taxpayer for the costs incurred in producing said duplicates.

Dated: New York, New York
June 2, 1976.

Respectfully submitted,

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Form 280 A-Affidavit of Service by Mail
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AFFIDAVIT OF MAILING

State of New York)
County of New York) ss

CA 76-6040

Marian J. Bryant being duly sworn, deposes and says that she is employed in the Office of the United States Attorney for the Southern District of New York.

That on the 2nd day of June, 1976 she served two copys of the within Reply Brief of Petitioners-Appellants-Cross Appellees

by placing the same in a properly postpaid franked envelope addressed:

Grubbs, Leahy & Donovan Esquires
27 Cedar Street
New York, New York 10038

And deponent further says she sealed the said envelope and placed the same in the mail chute drop for mailing in the United States Courthouse Annex, One St. Andrews Plaza, Borough of Manhattan, City of New York.

Marian J. Bryant

Sworn to before me this
2nd day of June, 1976

Lawrence Mason

LAWRENCE MASON
Notary Public, State of New York
No. 03-2572560
Qualified in Bronx County
Commission Expires March 30, 1977